Oregon Tax Court — Entities not unitary without centralized management, de minimis in-state activity is not 'doing business'

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UPDATE: On appeal, the Regular Division of the Oregon Tax Court on partial summary judgement ruled on January 26, 2015, that an "exchange of value" exists only when all three requirements of subparagraphs (A), (B), and (C) under ORS 317.705(3)(a) are satisfied.

In brief

The Oregon Tax Court held that shared officers among related entities did not satisfy the unitary requirement of centralized management or executive force. Additionally, an out-of-state entity was not 'doing business' in Oregon for Corporation Excise Tax purposes when two of its employees spent a total of four days in the state inspecting franchisee operations and providing training. Finally, a captive insurance company was unitary with its parent's combined group due to the economies of scale enjoyed by the group. [Rent-A-Center, Inc. et. al. v. Oregon Department of Revenue, Or. Tax Ct., No. TC -MD 111031D, (4/23/14)]

In detail

In 1996, Rent-A-Center, Inc. (RAC), the largest rent-to-own operator in North America, acquired ColorTyme, Inc., which sold rental equipment to franchisees who in turn offered the equipment to the general public for rent or purchase under a rental-purchase program. A wholly-owned subsidiary of RAC, Legacy Insurance Company, Ltd., wrote insurance policies to cover the operational risks of RAC and its other subsidiaries.

For the 2003 tax year at issue, the Oregon Department of Revenue asserted that ColorTyme was part of RAC's unitary group and, alternatively, that ColorTyme had nexus with Oregon. Additionally, the Department argued that Legacy was part of RAC's unitary group.

All three unitary group requirements must be satisfied in pre -2007 tax years

For the 2003 tax year, a unitary group was defined as a corporation or group of corporations that are engaged in business activities that constitute a single trade or business. An Oregon statute provided that a single trade or business meant a shared or exchange of value among members as demonstrated by: "(A) Centralized management or common executive force; (B) Centralized administrative services or functions resulting in economies of scale, ***and*** (C) Flow of goods, capital resources, or services demonstrating functional integration" (emphasis added).

The Department argued that certain Oregon case law and regulations supported an interpretation that the presence of *any* of the above three factors could support unity. However, the Oregon Tax Court found that all three of the above factors must be present to satisfy a unitary finding. Note that for tax years beginning on or after January 1, 2007, the law changed such that the 'and' became an 'or.'

Shared officers do not result in centralized management

Having concluded that all three statutory factors must be satisfied for a unitary finding, the tax court looked first at whether centralized management existed between RAC and ColorTyme.

Following RAC's acquisition of ColorTyme in 1996, ColorTyme did not substantially change how it operated its business, other than to limit its activities to franchise operations. ColorTyme's management and daily operations were under its control. There was no active daily management from RAC, no transfer of personnel, no centralized training, and ColorTyme's operating results were not considered for purposes of the compensation of RAC's management team. However, two of RAC's executive officers were members of ColorTyme's board of directors.

The tax court found that shared officers who did not direct or dictate ColorTyme's operations do not result in centralized management among the entities. Other factors evidencing a lack of centralized management included: (1) ColorTyme maintained its own brand, separate from RAC, and (2) ColorTyme franchisees and RAC stores were competitors in certain locations. In the absence of centralized management, the entities were not engaged in a unitary relationship.

Four days in-state to inspect and train is not 'doing business' in the state

To be subject to Oregon's Corporation Excise Tax, an entity must be 'doing business' in the state. An Oregon administrative rule provides that a corporation receiving franchise fees may be subject to the tax "if the corporation engages in activities that rise to the level of doing business in Oregon." Accordingly, the receipt of franchise fees alone does not subject a corporation to the tax.

The tax court examined the following in-state activities of ColorTyme to determine whether they amounted to 'doing business' in the state: (1) two employees spending four days in Oregon to physically inspect franchisee operations and to provide nonrecurring training, (2) the license of the use of its trademarks and computer systems, and (3) ColorTyme-owned manuals were provided to franchisees. The tax court held that these activities did not amount to doing business in the state.

Captive insurance company created economies of scale, included in combined return

The tax court examined whether RAC was unitary with its captive insurance company, Legacy. Since the parties agreed that functional integration and centralized management existed, the issue before the tax court was whether economies of scale resulting from centralized administrative services or functions existed.

The tax court found that the centralized administration of insurance in Legacy relieved RAC and its affiliates from administering that function. Legacy's contribution to RAC's affiliates created a substantial exchange of value. Accordingly, despite the fact that Legacy was directly managed by a foreign affiliate, the tax court found that centralized administration existed for unitary purposes.

The takeaway

The tax court's unitary analysis is instructive to companies that acquire independent businesses. Much like the recent California decision in *ComCon Production Services* (click here for our summary), *Rent-A-Center* highlights how maintaining separate operations and management can result in an entity remaining non-unitary following its acquisition.

The decision is also a useful reminder to taxpayers that a difference exists between a state's jurisdiction to tax (i.e., US Constitutional nexus) and a state's application of its tax to certain activities. The *Rent-A-Center* decision declined to address whether the taxpayer's activity exceeded US Constitutional limitations to tax because the tax court determined that the taxpayer was not 'subject to tax' under Oregon law. Oregon may have had to power to tax ColorTyme (though, we don't know for sure because the tax court did not rule on this), but the state limited its power by extending its tax to activities that qualify as 'doing business.' In the absence of evidence that ColorTyme was 'doing business' in Oregon, it was not subject to the Corporation Excise Tax.

Let's talk

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